

**DEPARTMENT OF STATE REVENUE**  
**LETTER OF FINDINGS NUMBER: 99-0127**  
**SALES AND USE TAX**  
**FOR TAX PERIODS: 1995-1997**

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**I. Sales and Use Tax: Manufacturing Exemptions**

**Authority:** IC 6-2.5-3-2 (a), IC 6-2.5-5-3, IC 6-2.5-5-5.1, 45 IAC 2.2-5-10 (c), 45 IAC 2.2-5-10 (h)(2), 45 IAC 2.2-5-12, *Indiana Department of Revenue v. Cave Stone*, 457 N.E. 2d 520, (Ind. 1983). *Rotation Products v. Indiana Department of State Revenue*, 690 N.E.2d 795, 803 (Ind. Tax. Ct. 1998), 2003 Indiana LEXIS 117.

The taxpayer protests the assessment of use tax on certain items of tangible personal property.

**II. Tax Administration: Abatement of Penalty**

**Authority:** IC 6-8.1-10-2.1, 45 IAC 15-11-2 (b).

The taxpayer protests the assessment of the penalty.

**Statement of Facts**

The taxpayer is in the business of selling, servicing, and rebuilding electrical motors, pumps, and gearboxes. After an audit, the Indiana Department of Revenue, hereinafter referred to as the "department," assessed additional sales and use tax, interest, and penalty. The taxpayer protested a portion of the assessment and a hearing was held to determine the sales and use taxability of certain items used in the taxpayer's rebuilding process.

**I. Sales and Use Tax: Manufacturing Exemptions**

The taxpayer agrees that some of its activities constitute repair. Materials used in the provision of a repair service are subject to the use tax pursuant to IC 6-2.5-3-2 (a). The taxpayer's protest to the assessment of tax on property used in the provision of repair services is denied.

The remainder of the taxpayer's protest concerns its tax liability in the rebuilding or remanufacturing of certain pumps and motors. In this process, the taxpayer typically picks up the non-working or poorly performing electric motors and pumps of its customers and transports them to its production facility. Such non-functioning or unusable motors and pumps are visually inspected and often tested by the taxpayer using a test panel in order to determine the mechanical problem at issue. The taxpayer then makes a determination as to the problem(s) involved and

whether the electric motor or pump is salvageable. Customers are then given a choice of purchasing a new motor or having the old motor remanufactured. Unsalvageable motors and pumps are discarded by the taxpayer.

If the motor or pump is salvageable and the customer desires remanufacture, the taxpayer's documentation indicates that ownership of the equipment transfers to the taxpayer. Then the taxpayer will disassemble the item down to its castings. Often heavy equipment is used to assist the taxpayer in the disassembly process. If the windings (windings are copper wires that are coiled to produce the proper magnetic field for the motor or pump) of the motor or pump need to be replaced, such windings will be removed. Removal of windings requires baking the motor in an oven to loosen the varnish on the windings, which is stripped after the baking process. The windings are then torn out of the slot in the motor frame. New windings are inserted and new paper insulation is added. Then varnish is applied to the windings and the windings are baked in the oven to harden the varnish. The new windings are often of similar design, or the taxpayer will install upgraded windings in order to make the motor or pump more efficient than when it was purchased. Often ball bearings, lubricants, lubricant meters and tubing, hydraulic pumps and systems, and other parts are replaced, as needed. Also, all gears, shafts and end bells (the part that holds shafts in place) will be inspected and realigned. If the shafts are bent or warped then they will be realigned using special equipment. Often a realignment or machining of a motor or its parts will require the motor to be rebalanced. If necessary, the end bells and pump shafts will be machined on metal lathes. Next, all welds will be redone as needed and the items will be varnished and painted. Finally, upon reassembly of the motor or pump, such remanufactured item will be retested on the test panel to determine its performance and capacity and if such performance and capacity has changed from its original specifications when the motor was newly purchased. Also, a new nameplate describing the item's amps and capacity is affixed to such item. Skilled technicians provide these functions. The taxpayer provides its customers with a one-year warranty on all remanufactured motors and pumps. The department's audit assessed use tax on many items used in this process. The taxpayer protested the assessment of use tax on the items it used in the rebuilding process. After the hearing, the taxpayer withdrew its protest to a portion of the items originally protested.

Pursuant to IC 6-2.5-3-2 (a), Indiana imposes an excise tax on tangible personal property stored, used, or consumed in Indiana. There is no exemption available for tangible personal property used in the provision of a service.

A number of exemptions are available from use tax, including those collectively referred to as the manufacturing exemptions. IC 6-2.5-5-3 provides for the exemption of "manufacturing machinery, tools and equipment which is to be directly used by the purchaser in the direct production, manufacture, fabrication . . . of tangible personal property." (the equipment exemption) In *Indiana Department of Revenue v. Cave Stone*, 457 N.E. 2d 520, (Ind. 1983) the Indiana Supreme Court found that a piece of equipment qualifies for the manufacturing exemption if it is essential and integral to the production process. 45 IAC 2.2-5-10 (c) describes manufacturing machinery and tools as exempt if they have an immediate effect on the property in production. 45 IAC 2.2-5-10 (h)(2) further clarifies the exemption by allowing the exemption of "Replacement parts, used to replace worn, broken, inoperative or missing parts or accessories on exempt machinery and equipment . . ." IC 6-2.5-5-5.1 provides for the exemption of tangible

personal property “. . . if the person acquiring the property acquires it for the direct consumption as a material to be consumed in the direct production of other tangible personal property in the person’s business of manufacturing, . . .” (the consumption exemption) Pursuant to 45 IAC 2.2-5-12, consumption of tangible personal property in the direct production process means “dissipation or expenditure by combustion, use, or application.. .” of the tangible personal property in an “essential and integral part of an integrated process which produces tangible personal property.”

Both the equipment and consumption manufacturing exemptions require that the subject item be used in a production process. The taxpayer contends that the protested items qualify for either the equipment or consumption exemption. The department assessed use tax on the protested items because the department determined that the items were used in the service of repairing engines and pumps rather than a true production process. The first issue to be determined here is whether the protested items were actually used in the provision of a service or in a production process as the taxpayer contends.

To support its contention that the taxpayer is actually remanufacturing the engines and pumps in a production process rather than providing a repair service, the taxpayer cites *Rotation Products v. Indiana Department of State Revenue*, 690 N.E.2d 795, 803 (Ind. Tax. Ct. 1998). In that case, Rotation Products Corporation successfully argued that it took raw materials in the form of unusable roller bearings and created an entirely new product, i.e., the remanufactured roller bearings. The Court found that this was a production process and not the provision of a service. To reach this conclusion, the Court instituted the following four-prong test to distinguish a production process from the provision of a service. First, a production process must be complex and substantial and produce a different end product. Secondly, the property must become more valuable in the process. Thirdly, the end product of the process must compare favorably with newly manufactured articles of its kind. Finally, the process must not be part of the normal life cycle of the original product.

First, like the taxpayer in Rotation Products, the taxpayer performs substantial and complex work and significantly changes the electric motors and pumps that it remanufactures. The taxpayer tests non-working or poorly working electric motors and pumps to determine the mechanical problem at issue. The taxpayer then determines the problems involved and whether the electric motor or pump is salvageable. If it is salvageable and the customer prefers remanufacture to the purchase of new equipment, the taxpayer disassembles the item. In a complicated multi-step process, the taxpayer then removes the old windings, discards the old windings, and installs new and often improved windings in the motor. This process is similar to the Rotation Products Corporation enhancing the bearings by adding new rolling elements and cages. *Id.* at 803-04. The new windings must then be varnished and the varnish baked in an oven. The taxpayer also replaces ball bearings, lubricants, lubricant meters and tubing, hydraulic pumps and systems as needed. This is also similar to the Rotation Products Corporation enhancing the bearings by adding new rolling elements and cages. *Id.* at 803-04. Next the taxpayer inspects and realigns as necessary all gears, shafts and end bells. Finally, the end bells are grounded, machined, and polished on metal lathes and joints are rewelded. The reassembled and remanufactured motor or pump is then tested to determine its capacity and output. After testing, a new nameplate describing the amps and capacity of the motor or pump is affixed to the item. The taxpayer

issues a one-year warranty with the remanufactured AC and DC wound motors or pumps and a two-year warranty on 3 phase motors similar to the warranty offered by the Rotation Products Corporation. *Id.* at 803.

Secondly, the property must become more valuable in the process. The taxpayer takes nonusable motors and pumps and transforms them into marketable motors and pumps. Before the remanufacturing process, the only value of the motors and pumps is as scrap metal. After the remanufacturing process, the motors and pumps are functional and oftentimes more powerful than the original item.

The remanufactured motors and pumps also compare favorably with similar new items. The remanufactured items sell for approximately 80% of the price of a new motor or pump.

Finally, the taxpayer's remanufacturing of the electric motors and pumps is not part of such property's normal life cycle. In *Rotation Products*, the Court noted that even if the cleaning and polishing of bearings is routine maintenance that is a normal part of such bearings' lifecycle; grinding bearing surfaces and replacing roller cages and elements are not. *Id.* at 803-04. Similarly, even if the taxpayer's cleaning, painting, and polishing the motors and pumps is routine maintenance in the normal lifecycle; the rewinding process, the shaft realignment, and the machining of end bells is not.

Application of the Court's test to the taxpayer's situation indicates that the taxpayer is engaged in the process of production of motors and pumps rather than the provision of a service.

Recently, the Indiana Supreme Court determined that to qualify for the manufacturing exemptions, a taxpayer must be involved in the production of a "distinct marketable good." Indiana Department of Revenue v. Interstate Warehousing, Inc., 2003 Indiana LEXIS 117. Further, the Court indicated that in order to be engaged in the production of a marketable good, the taxpayer must be producing something that will be sold. *Id.* at 9. The taxpayer meets this requirement as the documentation indicates that the taxpayer takes title to the motors prior to rebuilding and the taxpayer's customers purchase the motors back after rebuilding. It does not even appear that the customer will get the same motor back.

Since it has been determined that the taxpayer actually produces a marketable product in a production process, the second issue is to determine whether the protested items actually qualify for the equipment and consumption manufacturing exemptions. The taxpayer's explanations of the use of the items in the production process indicate that they qualify for either the equipment or consumption manufacturing exemption.

### **Finding**

The taxpayer's protest as to portion of materials used in the provision of the repair service is denied. The taxpayer's protest as to the materials used in the remanufacture of pumps and motors is sustained subject to a supplemental audit.

## **II. Tax Administration: Abatement of Penalty**

The taxpayer's final point of protest concerns the imposition of the ten per cent negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

"Negligence", on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence.

During the audit period, the taxpayer failed to pay sales or use tax on several types of items such as cleaning supplies, office supplies, and magazine subscriptions. The department's publications clearly indicate that purchase and use of these items is subject to the tax. The taxpayer's failure to pay tax according to the departmental instructions constitutes negligence.

#### **Finding**

The taxpayer's final point of protest is denied.

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